

**Response To Audit Staff Draft Report of Findings Related to
Audit of Continuing Property Records of Bell Atlantic**

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Response To Audit Staff Reports of Findings Related to Audit of Continuing Property Records of Bell Atlantic¹

Despite clear evidence that their conclusions are factually wrong and that the audit that underlies them is seriously flawed, the audit staff reports recommend that the Commission require substantive action based on the audit results. In fact, the audit cannot support any Commission action, much less the misguided recommendations in the audit staff report.

First, from a factual standpoint, the conclusions as to the amount of equipment that could not be found are demonstrably wrong. The simple fact is that Bell Atlantic found fully 97% of the items included in the audit staff's sample, and the bulk of the remaining 3% either have been accounted for as retirements or otherwise cannot fairly be characterized as "missing." Moreover, Bell Atlantic was able to find these items using its continuing property records and supplemental supporting documentation -- just as the Commission's rules envision. While Bell Atlantic previously provided the audit staff with documentation to prove that the equipment was found -- including item by item descriptions of where and how the equipment was found (along with photographs in many instances) -- that information inexplicably appears to have been essentially ignored in the audit staff reports.

Second, the fact that the audit staff did not find all of the items in the sample during their initial inspections is hardly surprising given the way the inspections were

¹ This consolidated response is filed on behalf of the seven pre-merger Bell Atlantic telephone companies -- serving the states of Delaware, Maryland, New Jersey, Pennsylvania, Virginia, West Virginia and Washington, D.C. -- as well as the pre-merger NYNEX telephone companies -- New York Telephone Company, and New England Telephone and Telegraph Company. The first seven companies are collectively referred

conducted. Auditors were given just minutes on average to locate an item, and very limited flexibility to acknowledge when items were found in different locations. Moreover, rather than correcting the results of the initial inspections as additional items that subsequently were found, the audit staff did just the opposite. It reclassified items that were found during the field visits to dramatically increase the number classified as not found. It did so, moreover, after the fact, and without any further inspection or explanation. Even in the most recent reclassification, which was purportedly made in response to the massive documentation supplied by Bell Atlantic in response to a release of a draft of this report – six volumes with item by item descriptions and backup -- the staff did little more than shuffle around the categorizations of a few items without making any substantial changes.

Third, as explained in the independent evaluation by Ernst & Young, these and other defects in the design of the audit render the results inherently unreliable. In particular, there simply is no statistically meaningful way to draw conclusions about the value of the investment base as a whole by extrapolating from the limited (and inherently flawed) sample used in the audit.

Fourth, even apart from these fundamental defects, the audits serve no clear purpose since their results cannot have any effect on rates. As an initial matter, the audit results cannot effect current rate setting for the simple reason that Bell Atlantic's rates are regulated under a pure price cap regime where rates are divorced from underlying accounting costs. In addition, the audit results could not have any effect on rates even under rate of return regulation because the continuing property records were never used

to here as Bell Atlantic-South. The remaining two companies are collectively referred to

as the basis for setting rates. Rather, rates historically were set based on a different set of records -- namely, the Uniform System of Accounts -- that are separate from the continuing property records and subject to separate controls.

Fifth, the recommendations that the audit staff makes based on its flawed report are themselves unreasonable. A “write-off” of dollars here is inconsistent with Commission rules and does not even meet the Commission’s own test for an extraordinary retirement. The other major recommendation of an 100% inventory would cost more than \$50 million and would serve no useful purpose. The reports do not even purport to weigh the substantial cost of such a requirement against the non-existent benefit in order to determine whether such action is truly in the public interest, or is merely a punitive requirement that exacts a punishment without subjecting the Commission to the normal standards of review for such action.

Finally, the audit staff reports ultimately serve to highlight the fact that neither the current audit nor the Commission's detailed record keeping rules serve any real purpose. This is especially true given that the records at issue here are not today, nor have they ever been, used in setting rates. Yet, to date, Bell Atlantic already has been forced to spend well over \$5 million on this audit and had its reputation sullied through leaks to the press concerning inaccurate and unsupportable draft audit conclusions.

For all these reasons, the current audit should be terminated, and the underlying rules governing the retention of property records should be fundamentally reformed to eliminate the costs and burdens imposed by a record keeping system that serves no real purpose.

as Bell Atlantic-North.

Argument

I. Bell Atlantic Found The “Missing” Equipment.

The core of the audit staff’s report is its proposed conclusion that between 7-10% of the sampled items “could not be found.” This statement is demonstrably wrong. In reality, Bell Atlantic was able to locate fully 97 percent of the equipment and has provided the staff with extensive documentation that proves it was located. *See Exhibit 1* for a summary of these results. In addition, Bell Atlantic has on multiple occasions offered to review the documentation with the audit staff and even urged the audit staff to revisit the central offices to see the equipment for themselves (although to date the audit staff has declined those offers).

Moreover, Bell Atlantic was able to find the equipment using its continuing property records together with its related supplemental records -- just as the Commission's rules envision. Because many of these records are stored in remote locations, they obviously could not be readily available at the inspection locations when the audit staff identified the specific sample items for the first time. And due to the detailed nature of many of these records, a time consuming review was required in some instances to correlate the documentation with the specific sample items.² Nevertheless, Bell Atlantic began submitting to the audit staff information documenting the fact that it had located the supposedly “missing” items almost immediately following the audit inspection of the Commission.

² Bell Atlantic produced to the audit staff supplemental records for more than 60% of the value of the “missing” sampled items. In many cases these supplemental records, including invoices, telephone equipment orders (TEO), and property record input forms were used to develop an audit trail to locate and support the selected item.

Most recently, Bell Atlantic submitted a comprehensive six volume set of backup materials that served both to synthesize and organize past submissions and to provide item by item narrative explanations (along with supporting documentation) of where and how each individual piece of equipment was located. In many instances, the materials even included photographs of the equipment.

The explanations for the items that were classified incorrectly by the audit staff reports as missing fall into five principal categories:

First, the audit reports classified a number of items as missing only because of the gap in time between when the FCC obtained the property records and when the audit staff conducted their inspection. The FCC obtained Bell Atlantic's records in April 1997. The audit staff conducted their inspections in June and July of that year. As a result of this lag, a number of items were retired after the property records were obtained by the FCC but before the inspection. Rather than accounting for this fact, the audit staff reports incorrectly classify these items as missing.

Second, the audit reports classify as "missing" a number of smaller items that were embedded in a piece of larger equipment so that a ready inspection was not possible. For example, one item is a drawer located inside a larger technology cabinet. The cabinet, which can not be powered-up without the drawer in place, was working when the audit staff inspected. But the drawer itself has no individual part number that can be inspected, so Bell Atlantic was not given credit for this item as found – despite the fact that it obviously does exist if the cabinet is in operation.

Third, the audit staff reports generally (though not consistently) treat as "missing" items that were found in the central office, but in a location that is different from the one

specified in the detailed property record. For example, in one office the staff selected a specific type of panel that was unique in that central office. It was found one frame over from the frame identified in the property records. Yet, while nothing in the rules requires the records to reflect the precise location below a central office level (and Bell Atlantic has included such detail only for its own convenience), this equipment was treated as missing – again, despite the fact that it demonstrably does exist.

Indeed, the reports themselves recognize that further investigation is warranted under these circumstances to clarify that such items correspond to the item in the property records:

For some items, additional audit work allowed auditors to conclude reasonably that the item shown was the item listed on the CPR. This additional work consisted of the auditor conducting an office count of like items to account for all such times in the central office or on the floor where the item was expected to be found. If the total number of such items at the location equaled the total number on the CPR for the office or floor, the auditor concluded that the item was found.

Audit Staff Reports, Appendix C at 1. While this procedure rarely was adhered to by the audit staff -- presumably because the audit staff only allowed six hours to physically inspect each office, or roughly ten minutes per item -- it was successfully adopted by Bell Atlantic in its post inspection review. Despite the endorsement of this procedure in the audit staff reports, however, the reports do not yet reflect the fact that many items were found through precisely this type of cross check.

Fourth, in some instances, the property record description differed slightly from the actual item. For example, one selection was described as panel boards, but was in fact fuse boxes that included a panel board as a component. This was verified by referencing the supporting invoices for the items. Such differences should not be

unexpected given the nature of the property record system. Even aside from the potential for a minor error in inputting the information, the property records systems themselves automatically include a description based upon an item's continuing property record identification number. If multiple descriptions are available for a particular identification number, absent direct manual override, the property record will always display the first choice in the list. Nonetheless, Bell Atlantic was able to confirm that the record and the equipment that it found were indeed a match by relying upon its supporting documentation – just as the Commission's rules themselves contemplate.

Fifth, Bell Atlantic uncovered situations where the "count" listed in the property records was incorrect. This occurred because the property records occasionally mis-identified “supplemental” items that should have been entered as a modification to the larger original item, like adding a new light bulb to a refrigerator. Under Bell Atlantic’s property records system, rather than track these minor items, they are entered under the same description as the main item, but with a count of zero. Where the supplemental item was not given a zero count, the audit reports assume that an additional unit of the main item is missing (*e.g.*, that another refrigerator was added rather than a light bulb). However, by checking the value of the items, as well as reviewing the supplemental records, Bell Atlantic was able to confirm those situations where there was no additional item, but rather a supplemental item was being counted as a main item.

In addition to these five categories of items that are properly classified as found in their entirety, some items also were partially found. For example, where the property record listed 12 items and 11 were found, that entry would not be classified as a find in the audit staff reports, but clearly the dollar value of the found items cannot be included

in a total of supposedly "missing" equipment. These partial finds, therefore, reduce the amount of the equipment that can be classified as missing still further.³

After all of these found or partially found items are taken into account, only 3% of the value of the equipment was left. But even of this remaining amount, at least half cannot fairly be characterized as "missing." The bulk of this equipment merely had been physically retired, but no retirement had been recorded yet in the records. For example, an energy control bay, while not retired in the records, had been removed in 1992. In the materials presented to the audit staff, however, Bell Atlantic not only provided work estimates for the replacement equipment, but also included pictures both of the original item and of holes in the floor left after the bay was removed. As a result, there is no question that the equipment did in fact exist. And while late retirements such as this may be considered a lapse in record keeping, any such lapse was minor and, as demonstrated in Section III below, there was no impact on rates.

In still other situations, there was no way to distinguish a particular item listed in the record from others in the office, but again, no basis to conclude that the item was missing. For example, to connect customer lines to a central office switch, Bell Atlantic builds metal distribution frames. As the number of lines handled by the office grows, the size of the frame grows to accommodate additional equipment. As the frame grows, frame components added in any given year become indistinguishable from the whole. But that hardly means they do not exist, particularly since these frames generally are not removed or retired except if there is a wholesale replacement of equipment. Therefore,

³ Moreover the audit staff did not give Bell Atlantic any additional credit when the count exceeded the count in the property records. These additional items, if "written-on," could potentially more than offset any "write-off" proposed by the staff.

while neither the audit staff reports nor Bell Atlantic treated these items as found, it is not reasonable to characterize these items as “missing.”

II. The Audit Procedures Were Flawed In a Number of Respects That Make the Results Inherently Unreliable For Any Purpose.

As explained in the attached independent evaluation of the audit procedures that was undertaken by Ernst & Young (Exhibit 2), the design of the audit was flawed in a number of material respects that render any conclusions inherently unreliable. In particular, the audit design suffered from four major defects which, individually or collectively, make it impossible to rely on any conclusions in the audit staff reports.

First, if the audit was intended to ascertain whether Bell Atlantic’s property records are overstated, it only looked at half of the equation. The audit attempted to begin with a sample of property records and then to find the equipment identified in those records. But the audit failed to even attempt the logical inverse of that – to begin with a sample of equipment and then to determine whether all of the equipment was listed in the property records. By failing to conduct such a “two-way” inspection, the audit failed to identify equipment that is in service but that is not recorded or exactly identified in the records. Indeed, there were instances where the total count of a particular item that was found in an office exceeded the number of such items listed in the property records. Yet Bell Atlantic not only received no credit for the extra items, but the audit staff failed to count any of the listed items as found. If they had done the full review, they may well have discovered additional equipment above and beyond any amounts that are now claimed to be missing. As explained by Ernst & Young, the failure to conduct such a two-way inspection alone fundamentally undermines the reliability of the audit staff reports.

Second, the actual process used to conduct the physical inspection was unsound (and caused equipment to be mistakenly classified as missing). Rather than use the property records to thoroughly investigate the location and disposition of equipment, as Bell Atlantic did, the auditors performed a cursory one-time inspection, allowing on average only ten minutes to discuss and inspect each selected item. The inspectors themselves were non-engineers who, because of the constraints of the audit process, never were given the opportunity to understand what they were inspecting, and missed equipment as a result. Whatever follow-up the audit staff did after the inspections, it did not involve any discussions with Bell Atlantic experts, despite frequent offers to hold such discussions. It also did not involve reinspections, despite offers for such visits as well. Moreover, the audit staff reports essentially ignore the documentation and other back-up materials that Bell Atlantic submitted to demonstrate that it was able to identify the overwhelming majority of the equipment that was missed in the initial inspections.

Third, the audit staff did several reclassifications of its audit results behind closed doors after the inspection. In the first such reclassification, which occurred relatively soon after the inspection, a relatively small number of items classified as “found” at the inspection site were reclassified as “not found” without any explanation. The second reclassification, which was far more substantial even though it was further removed from the time of the inspection, was first disclosed to Bell Atlantic in the initial draft audit reports. Without any explanation at all, the draft reports nearly doubled the value of the items classified as missing compared to the original audit results. *See Exhibit 3* for a quantification of those changes. This change was made despite the fact that additional information had been provided showing that even for the items originally classified as

“not found,” the vast majority actually were found and identified. The final adjustments made between the time of the initial draft reports and the release of the current audit staff reports leave these results substantially unchanged. Again, as explained in the report of Ernst & Young, this after the fact reclassification -- particularly in the absence of follow up site visits to try to confirm the reclassification -- renders the audit report results inherently unreliable.

Fourth, even apart from these underlying flaws, there simply is no statistically meaningful way to draw conclusions about the investment base as a whole by extrapolating from the limited sample used in the audit. The audit staff reports themselves already admit to a 40% margin of error. From a statistical standpoint, this means that no value within the range of possible values identified in the reports is more likely to be correct than any other. Consequently, the selection of a single number within that range, as the audit staff reports attempt to do, is statistically meaningless.⁴ Ernst & Young Report at 5.

Moreover, the already large margin of error that is acknowledged in the audit staff reports is itself based on mistakes in the underlying statistical analysis. When those mistakes are corrected, the margin of error becomes even wider. *See* Ernst & Young Report at 4, 5. In fact, the margin of error is so large for both Bell Atlantic South and North alike that it undermines any attempt to pick a single value; and if the Commission were to reclassify only a small portion of the equipment as found based on the documentation provided by Bell Atlantic, there is no basis for claiming that the correct value of the missing equipment is not zero.

In an effort to bolster the validity of their conclusions, the current audit staff reports added a second statistical justification relying on a so called “Bayesian approach” to statistical analysis. But using a second flawed approach to corroborate the first flawed approach adds nothing to the validity of the reports. A Bayesian approach creates a model using underlying assumptions about the sample. But the same flaws that undermine the primary statistical analysis undermine the Bayesian model. See Ernst & Young Report at 6-8. While the approach masks the flaws by putting them behind a model, the flaws do not go away. The result is a clear instance of garbage in, garbage out.

III. The Audit Staff Reports Provide No Basis To Question The Reasonableness of Current Rates.

The audit staff reports do not attempt to make a direct connection between the so-called “missing” equipment and the level of current rates; but the reports do claim that the records are used to evaluate company financial results, for cost allocations, for separations, to set initial prices going into price caps, to help determine the productivity factors, to calculate lower formula adjustments, and as inputs to forward looking costs models. In fact, the engineering records audited by the staff are not used for any of these purposes, which merely highlights the fact that neither the current audit nor the Commission's detailed accounting rules themselves serve any real purpose.

The reasons this is true are straightforward:

First, any conclusions about the level of investment are totally irrelevant to the way that rates currently are set. Rather, Bell Atlantic's interstate prices are subject to a price cap that is in no way dependent on accounting costs in general or investment levels

⁴ Indeed, as is the IRS practice, the more equitable choice is to pick the lowest number in the range. See Ernst & Young Report at 5, n.7.

in particular. *Implementation of the Non-Accounting Safeguards of Sections 271 and 272*, 11 FCC Rcd 18877, 18942 (1996) (quoting *Computer III Remand Proceedings*, 6 FCC Rcd 7571, 7596 (1991)) (price cap regulation “severs the direct link between regulated costs and prices”). As a result, Bell Atlantic's current rate levels are completely divorced from any measure of underlying accounting costs.

Second, even during prior periods when rates were connected in some way to accounting costs -- either directly under rate of return regulation or indirectly as a result of sharing requirements -- any conclusion about the level of investment reflected in the continuing property records could not have had any effect on rates. This is so for several reasons.

a. As an initial matter, the property records examined in this audit never have been the basis for setting rates. Rather, even under rate of return regulation, rates were determined based on a different set of records that are subject to a separate set of controls.

Specifically, rates historically were based on returns calculated from the company's FCC regulated books of account -- *i.e.*, the Uniform System of Accounts (“USOA”). The investment amounts recorded in the USOA are entered directly in those accounts based on the amounts actually paid by the company to procure and install equipment (*e.g.* vendor bills and capitalized labor). They are not based on the continuing property records.⁵ See PricewaterhouseCoopers Report at 2, attached as Exhibit 4.

⁵ These USOA records (and not the property records) also are used in cost allocations and separations and would be the basis for a lower formula adjustment. To the extent the Commission looked at cost data in setting the productivity factor, the USOA accounts were the basis. Similarly, to the extent a forward looking cost model

These USOA accounts contain separate safeguards to ensure that investment balances are tied to actual payments. PricewaterhouseCoopers identified separate controls that are in place for each step in that process. These accounting records and their associated controls were not the subject of this audit.

In short, the audit looked at the wrong records if the objective was to determine whether any rate adjustment was warranted.

b. What's more, the only link at all between the USOA accounting records and the continuing property records is that the property records are the source of information concerning the timing and amount of equipment that is retired. But, as explained in the attached affidavit of Dr. Ronald White (Exhibit 5), it is a "common occurrence" that regulated accounts do not reflect all of the retirements that have occurred. But this fact cannot be directly linked to any impact on a company's revenue requirement or its rates -- even under rate of return regulation.

The reason is a function of the way in which Bell Atlantic and other carriers regulated by the Commission handle depreciation. Under the pooled depreciation method employed by the Commission (known as a remaining life methodology), Bell Atlantic does not base depreciation on any individual pieces of equipment. Instead the depreciation recorded in the USOA accounts is based on life groups that include large pools of equipment. Moreover, when equipment is retired under this depreciation method, offsetting entries are made to remove the same dollar amount both from the plant accounts and from the depreciation reserves so that the net amount of the rate base

relies on actual costs at all (for example as a starting point to project how future costs will differ), it too would use the USOA costs and not the continuing property records.

remains the same.⁶ As Dr. White explains, therefore, there is no fixed relationship between a failure to retire plant and the revenue requirement – “[t]he amount, timing and present value of annual revenue requirements may increase, decrease or remain unchanged, depending upon the direction of movement in the composite remaining life of a plant category.” *See* White Affidavit at ¶ 6. Based on the relatively small amount of equipment in question, and based on the FCC’s methods for setting depreciation lives, however, Dr. White explains that “any change in remaining lives attributable to omitted retirements would be immaterial for Bell Atlantic.” *See Id.*

As a result, even if Bell Atlantic did not record retirements in a timely way on the books that were used at one time to set rates, that fact had no impact on rate levels.

c. Even if the audit had looked at the right records, there also would be no basis to assume that any errors in the records that exist today mean that the rate base was overstated at the inception of price cap regulation. Whatever the audit says or does not say about the current status of Bell Atlantic's records or about the amount of equipment that currently is in place, it sheds no light on the amount of used and useful equipment in place almost a decade ago. Indeed, the audit did not purport to investigate past record keeping practices, nor could it. The simple fact is that, over time, records are misplaced and equipment is moved to new locations or retired. As a result, an investigation of current record keeping practices provides no solid information about record keeping practices from a decade ago. And this is all the more true here, given the fact that 42% of

⁶ As the Commission has explained, the depreciation method it employs is self-correcting -- which is not an unintended result. When the Commission adopted its remaining life depreciation method, one justification for doing so was the fact that the method “automatically corrects” for retirements and thereby assures that the total value

the value of the items that were classified as not found by the audit staff reports were not even put into service until after the adoption of price cap regulation.

d. Moreover, the simple fact is that the Commission considered and rejected proposals to conduct a more detailed inspection of property records at the inception of price caps. In the price cap rulemaking, parties complained that the then “existing rates reflect inflated costs.” *Policy and Rules Concerning Rates for Dominant Carriers*, 4 FCC Rcd 2873, 3245 (1989) (Price Cap Notice of Proposed Rulemaking). The Commission, however, rejected proposals to conduct such an investigation at that time as “not in the public interest.” *Id.* at 3247. It concluded that the rates in effect as of July 1, 1990 “represent the culmination of years of developing, refining, and overseeing the Commission’s access charge process. The rates resulting from this system, while perhaps not perfect, in general represent the best that rate of return regulation can produce.” *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, 6814 (1990) (Price Cap Order).

Having consciously decided that it would take the then existing rates as they were, warts and all, it is too late to revisit that decision today. Ten years ago the Commission was seeking to make a clean break from rate of return and its dependence on detailed accounting cost data. To suggest that a decade later, when those initial rates have been adjusted over and over under the new price cap system, we should go back to rate of return as a basis to adjust rates is fundamentally arbitrary. And to pretend that

of the asset may only be depreciated once. *See Proceedings to Allocate Depreciation Reserve*, 87 FCC 2d 1112, 1113 (1981).

there is a direct correlation between the initial rates and current rates, as one must to make an adjustment, would be utterly capricious.⁷

IV. Undetailed Records Cannot Be Considered “Missing” Plant.

The audit staff reports also classify as “missing” equipment that is included in the property records in accounts identified as “undetailed” investment. There is no basis in the record to assume that this equipment is missing, however.

Indeed, the very term “undetailed” investment is something of a misnomer because the property records do include a number of details associated with this investment, including the vintage year, a central office location and an equipment type (circuit or switching). The undetailed account was created at the inception of the continuing property records to account for the plant already in place at that time and which therefore did not have a specific continuing property identification code assigned to it. Indeed, in its letter permitting the adoption of the continuing property records system, the FCC acknowledged that a less detailed record would continue to be used for

⁷ For the same reason, there is no argument that the property that supposedly is missing today justifies a refund to capture additional amounts that should have been shared during the period that sharing was in effect. Regardless, the Commission has no authority to order refunds here in any event. As the Supreme Court has made clear, it is a cardinal principal of ratemaking that a regulatory agency may not set rates retroactively. *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571 (1981). Indeed, under the so-called “filed-rate doctrine,” courts will hold carriers and their customers to filed tariffs even where the carriers have contractual obligations inconsistent with the tariffs. *AT&T Co. v. Central Office Tel., Inc.*, 118 S. Ct. 1956 (1998). Indeed, regulatory agencies may only order refunds where they have express statutory authority to do so -- in the Commission's case, only where it adheres to the “process under §204(a)(1).” *Illinois Bell V. FCC*, 966 F.2d 1478, 1481 (D.C. Cir. 1992). Where, as here, the rates in question are not suspended, no accounting order is entered, and no investigation is conducted under § 204, the Commission “never reaches” the final step in §204, “ordering a refund.” *Id.*

such plant until retirement.⁸ While there have been occasional additions to the value of the undetailed equipment account as additional types of property have been added to the continuing property records system, for the most part the balances in the undetailed accounts have been dramatically shrinking – either through conducting inventories which more specifically identify the equipment and allow it to be reclassified in the property records, or through retirements.

Moreover, while the audit staff dismisses Bell Atlantic's response to their data requests, in fact these responses provide additional documentation concerning a sample of undetailed equipment. In addition to rejecting this documentation without basis, the reports also provide no statistical analysis to suggest that this sample (just 33 line items) provides a basis to extrapolate to the entire base of undetailed property for whatever conclusions might be drawn after the responses are reviewed.

In any event, Bell Atlantic's treatment of undetailed equipment is reasonable:

1. Bell Atlantic-South. By 1994 the vast majority of what originally had been classified as undetailed investment for the Bell Atlantic-South states already had been identified and assigned detailed continuing property record numbers. Even so, the staff's April 20, 1994 audit letter questioned the then continuing levels of undetailed investment for these states. In response to that report, Bell Atlantic provided the Commission with its action plan to detail and retire virtually all of the value in the undetailed accounts.⁹

See Letter from Gerald Asch to Jose-Luis Rodriguez (Aug. 1, 1994) ("Aug. 1 Letter").

⁸ Letter from Kelly Griffith on behalf of the Chief, Common Carrier Bureau to Alexander L. Stott, Vice President and Comptroller, AT&T (Dec. 24, 1968) ("Dec. 24 Letter").

⁹ *See* Exhibit 6 for a brief description of Bell Atlantic-South's resolution of other issues from the 1994 audit.

The staff audit report confirms that Bell Atlantic-South accomplished its goal with a “significant decrease of about 99 percent from Undetailed Investment balance at December 31, 1993.” *See* Bell Atlantic-South Staff Report at 12, n.41. Bell Atlantic informed the Commission that some equipment would remain undetailed; for example, “[d]ue to National Security issues, equipment residing at the Pentagon, White House, FBI and similar government installations will remain ‘undetailed.’” *See* Aug. 1 Letter at 1. For the first time, four years after Bell Atlantic informed the Commission of its exact plan with regard to undetailed investment, the staff report now complains that the remaining undetailed investment should be considered “missing.”¹⁰ In fact, as Bell Atlantic informed the audit staff, that amount has already been reduced through further retirements. As of the end of March, the remaining balance of undetailed investment was only \$92 thousand.

2. Bell Atlantic-North. In contrast, the FCC never issued any letter with audit findings with respect to the 1994 audit of the Bell Atlantic-North states.¹¹ Nevertheless, Bell Atlantic-North undertook on its own to remove undetailed investment from its records. A significant amount of the investment was detailed or retired as a result of internal inventories. As a result of these efforts, the investment classified as undetailed

¹⁰ In addition, despite being informed both before and after Bell Atlantic began its retirement of the bulk of this investment, the staff report now questions how Bell Atlantic reduced the levels of undetailed equipment.

¹¹ Appendix A of the staff report purports to summarize what the staff “found” in the 1994 audit. The draft report provided to Bell Atlantic in 1998 was the first documentation of any findings that has been communicated to Bell Atlantic-North.

was reduced from the \$377 million cited by the audit report here to only \$147 million, of which only \$62 million is in central office equipment accounts.¹²

Of the remaining undetailed investment, \$107 million is associated with remote locations – customer premises and other areas outside the central offices. These locations are so numerous and the amount of equipment in each is so small, that it would be prohibitively expensive to inventory the equipment at all these locations. Moreover, equipment at remote locations generally stays in place until there is a wholesale replacement or retirement of equipment at the location. Whenever such event occurs, Bell Atlantic retires all the undetailed equipment for the location.

The rest of the undetailed investment (in central office locations) is being retired according to its age. Any equipment more than ten years old has already been retired. Each year, any portion of the remaining investment that becomes ten years old is also retired. This process, which was reviewed with the Commission staff in 1995, will virtually eliminate undetailed investment over the coming years.

¹² A portion of this investment included in the undetailed property records is technically unallocated investment. In several accounting simplification projects, New York Telephone eliminated non-standard account numbers. As a result, certain unallocated investment was reclassified as undetailed to allow for specific investment identification (such identification cannot be assigned to investment classified as unallocated). Because this investment was initially classified as unallocated, Bell Atlantic did not attempt to separate undetailed and unallocated in responses to data requests.

V. The Records Are Not Deficient.

The audit staff reports (p. 2) also argue that over 20% of Bell Atlantic's records contained "substantive deficiencies and did not comply with the Commission's rules." Despite the broad language of this claim, the audit staff reports do not suggest that the general form of Bell Atlantic's property records are inconsistent with the Commission's rules, nor could they. The current property record system is just a variation of the original system started by AT&T and reviewed and accepted by the Commission. *See* Dec. 24 Letter.

Instead, the basis of the audit staff's claim is that the records are deficient because they fail with regard to their intended purpose – as a guide to finding the listed equipment. But this is wrong as a matter of fact. As explained above, almost all of the sampled items were identified using the records, either through the audit staff's initial review or through Bell Atlantic's follow-up review.

Indeed, the audit staff reports include among the "deficient records" items that the audit staff concedes that it was able to find using these same records, even under the constraints of the limited inspection conducted by the audit staff. These items were included in the audit staff's "category 2," which consists of items that were in fact found, and merely were "found in other locations."¹³ These "other locations" were overwhelmingly within the same central office but may have been located in a different shelf or bay. But identifying items to the exact bay and shelf position has never been a

¹³ In contrast, items designated as category 4 according to the reports (sample results attachment), "could not be verified as either found or not found for various reasons."

requirement of the Commission’s rules. The rules only require that the property be located “within each accounting area,” which is the “the smallest territory of the company for which accounting records of investment are maintained for all plant accounts within the area” -- in other words, a central office. 47 C.F.R. §§ 32.2000(f)(5); 32.2000(f)(1)(i). While Bell Atlantic’s property records typically include more detailed information than is required by the rules as a tool to assist its engineers, it makes no sense to fault Bell Atlantic when the records are correct at the central office level – as required by the rules – and only differ as to the more detailed location within the central office. All such an interpretation would do is to force Bell Atlantic to stop including the specific bay or shelf information in its records altogether.

As set forth in sections I and II, even for the equipment that the audit staff did not find in its limited inspection, the same records were sufficiently clear and correct to enable Bell Atlantic to find and identify the equipment.¹⁴ The rules require nothing more. While the rules do anticipate using the records for “spot checks” to find the equipment – such language should not be translated into the superficial checks conducted by the audit staff. Given the known errors in their reviews, such a requirement would hold carriers to an impossible standard that is defined nowhere in the rules.

VI. The Commission Should Reject The Audit Staff Report Recommendations

¹⁴ Even for the relatively small number of items where Bell Atlantic could not find the equipment, there is no basis for finding a violation of the rules. As explained above, the bulk of these records reflect equipment that had been removed from service, but for which the retirement records had not been processed in a timely manner. In almost all cases, the value of this equipment was less than \$50,000. For such equipment, the Commission rules specifically indicate that the timing requirements for retirement “is not required if an unreasonable amount of recordkeeping and estimating of quantities, original costs and salvage is necessary.” 47 C.F.R. § 32.2000 (d)(1).

The audit staff report makes several recommendations, none of which can be justified by the audit results. As a preliminary matter, all of the recommendations are based on the audit conclusion that equipment was “missing.” Because, as demonstrated above, the audit proves nothing of the kind, there is no underlying basis for the audit staff recommendations. Moreover, each of the recommendations are themselves flawed and should be rejected on their own merits.

First, the audit staff recommends a “write-off” of hundreds of millions of dollars to remove central office investment from Bell Atlantic’s “equipment accounts.” The term “write-off” appears in part 32 in reference to money paid for assets over their fair market value. This excess amount is “written-off” and treated as an expense rather than capitalized. 47 C.F.R. § 32.6565(b). That provision is clearly inapplicable here. Instead, what the audit staff really appears to contemplate is an extraordinary retirement. But even if the audit results had validity, which they do not, the Commission rules do not allow for an extraordinary retirement under these circumstances. Among the requirements that must be met before such a retirement is permitted are: that 1) the retirement was not considered in setting past depreciation rates; and 2) the charge will not unduly deplete the depreciation reserve. 47 C.F.R. § 32.2000 (g)(4). Neither of these conditions are satisfied here.¹⁵

Moreover, because the audit only looked at a tiny sample of actual plant accounts, the audit staff report provides no guidance as to what specific plant should be retired. If

¹⁵ Similarly, there is no basis to reverse past retirements that took place years before this audit report and treat the equipment retired there as an extraordinary retirement. In fact, the process for those retirements was shared with Commission staff at the time and there was no suggestion that they should not be treated as ordinary retirements.

Bell Atlantic were actually required to do as the audit staff suggests, any such retirements would guarantee that Bell Atlantic's artificially reduced general ledger and its engineering property records would no longer reflect the same equipment. This would make it impossible to do an annual reconciliation and to balance the two measures as is required under Commission rules. *See* 47 C.F.R. § 32.2000 (e)(2)(iii).

The audit staff reports also recommend that Bell Atlantic be required to engage an independent firm to perform an inventory of "its entire COE" and report its findings to the Commission. This is a remarkable suggestion in an era where the Commission says its wants to cut back on reporting and other unnecessary regulatory requirements in recognition of a more competitive marketplace. Moreover, the imposition of a requirement of this magnitude without a rulemaking is unprecedented and unwarranted.

Bell Atlantic already does internal inventories of its central office equipment, but it does them over an extended period of years to conserve resources and avoid disruption of the business. It would be fundamentally unsound as a matter of business practice, however, to attempt such an undertaking in a compressed time period. Indeed, even without taking into account the substantial disruption to the business, the costs of such an inventory would be between 50 and 100 million dollars.

Moreover, this massive expenditure would be pointless and the money would be wasted. The level of Bell Atlantic's investment has no impact on current rate levels, which are set under price cap regulation without regard to any company-specific cost, and the engineering records would not be used to set rates under this or any other form of regulation. No matter what the findings of a 100% inventory, they would not affect rates. As a result, the audit appears to be a back-door device designed to punish Bell Atlantic

by imposing unnecessary costs on it. Whatever the motivation, there is no legitimate justification for such a requirement.

Finally, the audit staff recommends yet another independent auditor, this time to review the process associated with practices and processes for maintaining the property records. While Bell Atlantic welcomes a process review, the audit staff recommendation falls short of what is required. The audit staff assumes that the current rules should be maintained and the only question is how Bell Atlantic should comply. This misses the bigger picture uncovered by this audit. The Commission should recognize that the property record rules that were designed for a single monopoly provider regulated under rate of return are not appropriate in today's market. Rather than seek out new regulatory burdens to impose on carriers, the Commission should work with the industry to craft rules that provide the Commission with the information it needs without imposing arcane burdens on regulated carriers.

Indeed, given the Commission's moves away from reliance on accounting information as the basis for rate setting, the Commission is obliged to review to what extent the current rules are still "necessary" to serve the public interest. 47 U.S.C. § 161(b). Regardless, the Commission may not use an audit investigation to expand the scope of the rules and create new requirements without a rulemaking. *See Northeast Cellular Tel. Co. v. FCC*, 897 F.2d 1164, 1166 (D.C. Cir. 1990) (FCC must articulate standards in advance of enforcing requirement); *see also* 5 U.S.C. § 556(d).

Conclusion

The Commission should reject the audit staff reports and terminate the audit without further action.

Respectfully submitted,

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